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No. 03-932

SEP 13 2004

IN THE

Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR PETITIONERS

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and the investment's subsequent decline in price.

LIST OF PARTIES AND CORPORATE DISCLOSURE STATEMENT

The parties to the proceedings below are listed in the caption. In the caption page to its opinion, 339 F.3d 933 (9th Cir. 2003) (Pet. App. 1a-17a), the Ninth Circuit inadvertently listed certain non-parties as defendants/appellees. Merrill Lynch and Co./Merrill Lynch, Pierce, Fenner and Smith, Inc. and James C. Blair were omitted by the plaintiffs/respondents from the Consolidated Amended Complaint and did not appear before the court of appeals. Nissan Motor Co., a Japanese corporation, was never a party in this case.

Pursuant to Supreme Court Rule 29.6, petitioner Dura Pharmaceuticals, Inc. states that on December 31, 2001 Dura Pharmaceuticals, Inc. merged with and into Elan Pharmaceuticals, Inc., a privately held Delaware corporation, which is a wholly-owned subsidiary of Elan Corporation, plc. a publicly-traded entity.

TABLE OF CONTENTS

	Page
Question Presented	i
List of Parties and Corporate Disclosure Statement	ii
Table of Contents	iii
Table of Cited Authorities	vi
Opinions Below	1
Statement of Jurisdiction	1
Statutory Provisions Involved	2
Statement of the Case	4
A. Factual Background	5
B. Respondents' Multiple Pleading Attempts	6
C. The District Court's Dismissal of the SAC	7
D. The Ninth Circuit's Decision	9
Summary of Argument	11

Contents

Page

Argument 14

I. The Ninth Circuit's Approach Is Inconsistent With The Reform Act 14

A. The Ninth Circuit's Interpretation Of Loss Causation Cannot Be Reconciled With The Reform Act's "Look Back" Damages Provision 15

B. The Ninth Circuit's Understanding Of Loss Causation Cannot Be Reconciled With The Definition Of That Term In Section 105 Of The Reform Act 18

II. An Allegation Of Price Inflation, Standing Alone, Is Not Sufficient To Satisfy The Loss Causation Pleading Requirement 21

A. The Reform Act Clearly Intended To Codify Existing Case Law That The Misrepresentation Must Cause The Investment's Decline In Value 22

B. The Ninth Circuit's Decision Nullifies Loss Causation As An Essential And Independent Element Under Rule 10b-5 26

Contents

Page

1. The Ninth Circuit's Price Inflation Theory Improperly Collapses Loss Causation Into Transaction Causation 27

2. The Ninth Circuit's Interpretation Of Loss Causation Is Counterintuitive To The Efficient Market Theory 30

C. The Ninth Circuit's Reliance On A Price Inflation Theory To Satisfy Loss Causation Contravenes Established Tort Principles 31

D. The Ninth Circuit's Price Inflation Theory Creates A Potential Windfall For Certain Investors 34

III. Respondents' Anticipated Alternative Theories Of Loss Causation Are Unsustainable 35

Conclusion 37

TABLE OF CITED AUTHORITIES

Page

Cases:

AUSA Life Ins. Co. v. Ernst & Young,
206 F.3d 202 (2d Cir. 2000) 29

Basic Inc. v. Levinson,
485 U.S. 224 (1988) 28, 29, 31

Bastian v. Petron Resources Corp.,
892 F.2d 680 (7th Cir. 1990) 24, 25, 26

Central Bank of Denver, N.A.
v. First Interstate Bank of Denver, N.A.,
511 U.S. 164 (1994) 20, 31

Chiarella v. United States,
445 U.S. 222 (1988) 20

Dura Pharmaceuticals, Inc. v. Broudo,
124 S. Ct. 1625 (2004) 10

Emergent Capital Investment Management, LLC
v. Stonepath Group, Inc.,
343 F.3d 189 (2d Cir. 2003) 13, 29

Estate of Cowart v. Nicklos Drilling Co.,
505 U.S. 469 (1992) 20

FDA v. Brown & Williamson Tobacco Corp.,
529 U.S. 120 (2000) 19

Page

Huddleston v. Herman & MacLean,
640 F.2d 534 (5th Cir. 1981) ..... *passim*

Raab v. General Physics Corp.,
4 F.3d 286 (4th Cir. 1993) 22

Reno v. Koray,
515 U.S. 50 (1995) 19

Robbins v. Koger Properties, Inc.,
116 F.3d 1441 (11th Cir. 1997) 10, 29

Schlick v. Penn-Dixie Cement Corp.,
507 F.2d 374 (2d Cir. 1974) 12, 27

Semerenko v. Cendant Corp.,
223 F.3d 165 (3d Cir. 2000) 10, 30, 34

Sullivan v. Stroop,
496 U.S. 478 (1990) 20

United Savings Ass'n of Texas
v. Timbers of Inwood Forest Assocs., Ltd.,
484 U.S. 365 (1988) 20, 23

Statutes & Rules:

15 U.S.C. § 77*l* 4

15 U.S.C. § 77*l*(b) 18, 31-32

15 U.S.C. § 78a, *et seq.* 2

Page

15 U.S.C. § 78j(b) 26

15 U.S.C. § 78u-4 2

15 U.S.C. § 78u-4(b)(4) ..... *passim*

15 U.S.C. § 78u-4(e)(1) 16

28 U.S.C. § 1254(1) 1

17 C.F.R. § 240.10b-5 ..... 26, 27, 28

Fed. Rule of Civil Procedure
12(b)(6) 35

Securities Exchange Act of 1934
Section 10(b) ..... *passim*

Securities Exchange Act of 1934
Rule 10b-5 ..... *passim*

Securities Exchange Act of 1933
Section 12 18

Private Securities Litigation Reform Act of 1995,
P.L. 104-67, 1995 HR 1058 ..... 2, 11, 15, 18

H.R. Conf. Rep. 104-369 (1995),
reprinted in 1995 U.S.C.C.A.N. 730 ..... 14, 22, 23

S. Rep. No. 104-98 (1995),
reprinted in 1995 U.S.C.C.A.N. 679 ..... 17, 23

Page

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68 Fordham L. Rev. 1781, April 2000 29

W. Prosser & W. Keeton, Prosser and Keeton on Torts
¶ 110 (5th ed. 1984) 32

Restatement (Second) of Torts
§ 548A cmt.b (1997) 33

Restatement (Second) of Torts
§ 548A cmt.b, illus. 1 (1997) 33

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit filed August 5, 2003, is reported at 339 F.3d 933 (9th Cir. 2003) and reprinted at Pet. App. 1a-17a. The unreported order denying the petition for panel rehearing and rehearing *en banc* is reprinted at Pet. App. 52a-53a. The order of the district court granting petitioners' motion to dismiss the consolidated and amended complaint without prejudice is reported at 2000 WL 33176043 and Fed. Sec. L. Rep. (CCH) P 91, 245. The subsequent order of the district court granting petitioners' motion to dismiss the second amended complaint with prejudice is not reported, but is reprinted in the Appendix ("Pet. App.") at 18a-51a.

STATEMENT OF JURISDICTION

The court of appeals entered its opinion and order on August 5, 2003. A timely petition for rehearing and rehearing *en banc* was filed. On September 29, 2003, the panel denied the petition for rehearing and the suggestion for rehearing *en banc* was rejected.

The petition for writ of certiorari was filed on December 24, 2003, and was granted on June 28, 2004. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78a, *et seq.*, including the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), P.L. 104-67, 1995 HR 1058, involved are:

15 U.S.C. § 78u-4

(b) Requirements for securities fraud actions

* * *

(4) Loss Causation

In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.

* * *

(e) Limitation on damages

(1) In general

Except as provided in paragraph (2), in any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff

for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception

In any private action arising under this chapter in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

* * *

These provisions are also reproduced at Pet. App. 54a-55a. In addition, the following provision under Section 12 of the Securities Act of 1933 is pertinent to the Court's consideration of this case:

15 U.S.C. § 77*l*

(b) Loss causation

In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

STATEMENT OF THE CASE

The question presented in this case concerns the proper standard for pleading the now Congressionally mandated element of "loss causation" in a private securities fraud claim brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. *See* 15 U.S.C. § 78u-4(b)(4). Specifically, this case concerns whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving a causal connection between the alleged fraud and a subsequent and corresponding decline in the value of the plaintiff's investment. In other words, where a plaintiff invokes the fraud-on-the-market theory to recover damages for a post-transaction decline in share price, must the plaintiff

allege that the defendant's alleged fraud actually caused that decline? In overturning the district court's dismissal of the plaintiffs' complaint on this basis, the Ninth Circuit has required no such causal link. According to the Ninth Circuit, in a fraud-on-the-market case, a plaintiff establishes loss causation on a bare allegation that a share's price on the date of purchase was "inflated" as a result of the alleged fraud – no showing of a subsequent decline in price associated with removing the alleged "inflation" is necessary.

A. Factual Background

Petitioner Dura Pharmaceuticals, Inc. ("Dura") was a San Diego-based developer and marketer of prescription pharmaceutical products for the treatment of allergies, asthma, and related respiratory conditions. The individual petitioners herein held various management and/or director positions with Dura. Respondents are investors who purchased shares of Dura between April 15, 1997 and February 24, 1998 (the "Class Period").

On February 24, 1998, Dura announced that it expected a revenue shortfall for the upcoming full year due to anticipated slow pharmaceutical sales, increased competition and a need to increase Dura's sales force. Joint Appendix ("JA") 142a-147a, 191a-194a; 51a: ¶ 32. The announcement said nothing about Albuterol Spiros, Dura's delivery device for asthma medication, which was in development in coordination with the United States Food and Drug Administration ("FDA"), but not yet FDA-approved. *Id.* Following this announcement, Dura's stock dropped from

$39.125 on February 24, 1998 to $20.75 on February 25, 1998, a 47% one-day loss. JA 51a: ¶ 32 [1]

On November 3, 1998, nearly nine months after Dura's February 24, 1998 announcement and the concurrent loss in stock price, Dura announced that the FDA did not approve Albuterol Spiros due to issues of electro-mechanical reliability and the need for additional clinical trials. JA 110a-111a: ¶ 136. Dura's share price declined somewhat following the November 3 announcement, from $12.375 to $9.75. JA 142a-147a, 156a. Within twelve trading days, however, the stock price recovered to $12.438, and within ninety days it closed at $14.00 per share. *Id.*

B. Respondents' Multiple Pleading Attempts

Respondents filed their initial complaint on January 27, 1999, nearly a year after the end of the alleged Class Period. Supplemental Excerpts of Record from the Ninth Circuit ("SER") 1. After the district court appointed lead plaintiffs and approved their choice of co-lead counsel, respondents filed a Consolidated Amended Complaint ("CAC") on October 7, 1999. SER 37. Respondents alleged that petitioners made materially false statements during the Class Period regarding, inter alia, the prospects of Albuterol Spiros. *Id.*: ¶¶ 20-23, 31. Respondents did not seek to recover losses associated with the November 3, 1998 announcement concerning Albuterol Spiros. SER 37. Indeed, nowhere in the CAC did respondents even mention the November 3, 1998 price decline. *Id.* Rather, respondents sought to recover for

1. Plaintiffs rely upon intra-day trading highs and lows in Dura common stock to enhance their allegations. On February 24, 1998 Dura's shares closed at $38.125. *See* JA 142a-147a, 162a. On February 25, 1998 Dura's shares closed at $23.938. *Id.*

the 47% decline in price that followed the February 24 announcement of an anticipated prospective revenue shortfall. *Id.*: ¶¶ 30, 36, 61, 93. On July 12, 2000, the district court granted petitioners' motion to dismiss the CAC without prejudice. SER 68. The district court admonished respondents that failure to comply with the requisite pleading standards may subject their complaint to dismissal with prejudice. SER 68, p. 26.

Respondents filed a Second Amended Complaint ("SAC") on September 25, 2000. JA 34a-141a. Similar to the CAC, respondents alleged, inter alia, that during the Class Period petitioners misled investors regarding the likelihood of FDA approval of Albuterol Spiros by failing to disclose that the products suffered from "electro-mechanical" defects and that Dura had made changes to the products during clinical testing, which would prevent the approval of its New Drug Application ("NDA") filed with FDA. *Id.*: ¶¶ 22-23, 33, 66-70. Similar to the allegations contained in the CAC, respondents did not mention the November 3, 1998 price decline associated with the announcement concerning Albuterol Spiros. JA 110a-111a. Respondents only sought to recover losses for the 47% price decline following the earlier February 24 announcement, which respondents do not allege made any mention of Albuterol Spiros. JA 34a-141a: ¶¶ 32, 39, 134, 172.

C. The District Court's Dismissal of the SAC

On November 2, 2001, the district court granted petitioners' motion to dismiss the Second Amended Complaint with prejudice and entered judgment in petitioners' favor. Pet. App. 51a. The district court found, in relevant part, that respondents' allegations concerning

Albuterol Spiros were insufficient to state a claim because plaintiffs failed to plead the requisite "loss causation."[2] Specifically, the district court focused on the end of the Class Period and Dura's announcement on February 24, 1998 which was followed by a stock price decline:

> The SAC does not allege that the February 24, 1998, announcement contained any negative information about Albuterol Spiros. Rather, Dura did not announce that the FDA would not approve Albuterol Spiros until nine months later, in November 1998. (SAC ¶ 136.) The SAC does not contain any allegations that the FDA's non-approval had any relationship to the February price drop. Accordingly, the SAC does not explain how the alleged misrepresentations and omissions regarding Albuterol Spiros "touched" upon the reasons for the decline in Dura's stock price. Rather, the decline in Dura's stock price was the result of an expected revenue shortfall.

Pet. App. 40a. The district court noted that because the February 24 announcement did not mention the Albuterol Spiros device, no omissions or misrepresentations about the device caused the decline in price. The district court expressly rejected respondents' contention that they had properly pleaded loss causation because they alleged that the stock price on the date of purchase was inflated because of the misrepresentations or omissions and they would not have purchased the stock had they known about the petitioners' wrongdoing. Pet. App. 40a.

2. In granting petitioners' motion to dismiss with prejudice, the district court also found that respondents failed to allege particularized facts establishing that any material statements were false or misleading when made, and failed to allege particularized facts establishing a strong inference of scienter. Pet. App. 18a-51a.

D. The Ninth Circuit's Decision

On respondents' appeal, the Ninth Circuit reversed the district court's dismissal of the SAC. Pet. App. 17a. The court of appeals acknowledged, consistent with the district court's reasoning, that the loss causation element is satisfied in the Ninth Circuit if "the plaintiff shows that 'the misrepresentation touches upon the reasons for the investment's decline.'" Pet. App. 8a. However, the Ninth Circuit found the "touches upon" language ambiguous. *Id.*

According to the Ninth Circuit, in a fraud-on-the-market case, plaintiffs establish loss causation if they plead that the stock price on the date of purchase was inflated because of the misrepresentation. Pet. App. 9a. The court of appeals concluded that the "injury" occurs at the time of the transaction and therefore, it is not necessary that a market price drop actually occur in order to establish loss causation. *Id.* According to the court of appeals, in order to establish loss causation, a plaintiff is not required to plead a stock price drop following a corrective disclosure. *Id.* Rather, to withstand a motion to dismiss, a plaintiff need only allege (1) that the price at the time of purchase was overvalued and (2) sufficient identification of the cause for the overvaluation. Pet. App. 10a.[3]

3. In addition to its holding regarding loss causation, the court of appeals also vacated and remanded the district court's finding of no allegations establishing a strong inference of scienter, instructing the district court to consider the plaintiffs' allegations of scienter in their totality, rather than separately. The court of appeals further found that the district court abused its discretion in denying leave to amend the SAC. Pet. App. 14a-16a. Because the court of appeals held that respondents had sufficiently pleaded loss causation by alleging artificial inflation at the time of purchase, respondents' potential amendments to the SAC will not affect the loss causation issue.

The court acknowledged that in contrast to its interpretation of loss causation, the Third and Eleventh Circuits apply a different standard. Those circuits, the court explained "do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint." Pet. App. 9a n.4 (*citing Semerenko v. Cendant Corp.*, 223 F.3d 165, 185 (3d Cir. 2000), *cert. denied*, 531 U.S. 1149 (2001), and *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997)).

Petitioners sought from this Court a writ of certiorari to review the judgment of the Ninth Circuit. On March 8, 2004, the Court invited the Solicitor General to file a brief in this case expressing the views of the United States. *Dura Pharmaceuticals, Inc. v. Broudo*, 124 S. Ct. 1625 (2004). In its brief filed on May 28, 2004 in support of granting certiorari, the Solicitor General and the Securities Exchange Commission strongly opposed the Ninth Circuit's interpretation of loss causation, describing the Ninth Circuit's holding as "incorrect" and "erroneous." (SG Cert. Brief at 1, 6, 9, 10, 11). The Solicitor General clearly indicated that in order to establish loss causation, there must be an actual reductive effect in the price of the stock that results from disclosure of the alleged misrepresentation. As the Solicitor General reasoned:

> it cannot be said that an investor in a fraud-on-the-market case who purchases a security at an inflated price has suffered *any* loss at the time of purchase, much less one caused by the defendant's misrepresentation. . . . Measuring the loss in such a case as of the time of purchase, and not requiring any allegation of a *subsequent* loss of value

> attributable to the fraud, would grant a windfall to investors. . . .

(SG Cert. Brief at 11) (emphasis added).

On June 28, 2004, this Court granted certiorari.

SUMMARY OF ARGUMENT

There can be no question that in order for the loss causation requirement to have any meaningful application at the pleading stage, a plaintiff invoking the fraud-on-the-market theory must establish a causal connection between the defendant's alleged fraud and the post-transaction decline in stock price for which the plaintiff seeks to recover losses. The Reform Act, which codified the long recognized loss causation requirement in private securities fraud actions, specifically requires that a plaintiff plead and prove "that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). Contrary to the plain language of the Reform Act and well-established precedents regarding loss causation, the Ninth Circuit requires only that a plaintiff plead that the price of stock was artificially inflated at the time of purchase. As the Ninth Circuit held "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred. . . ." The Ninth Circuit's decision here has taken the "loss" out of "loss causation," thereby turning the required element on its head.

When viewed in light of the overall statutory scheme, the Ninth Circuit's interpretation of loss causation cannot be reconciled with the provisions of the Reform Act.

Particularly, the price inflation theory of loss causation is inconsistent with the Reform Act's limitation of damages provision, which defines a plaintiff's damages in terms of a post-transaction decline in value following a corrective disclosure. It is similarly inconsistent with the definition of loss causation contained elsewhere in the Reform Act, which defines loss causation as the link between a defendant's misconduct and a depreciation in the value of stock.

Since at least as early as 1974, loss causation has been recognized as a required element of private securities fraud claims brought under Section 10(b). *See Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974). Loss causation, which requires a plaintiff to show that the alleged misrepresentation caused the plaintiff's loss, is independent from the separate element of transaction causation, which requires a plaintiff to demonstrate that he relied upon a defendant's alleged misrepresentation when making his investment decision.[4] Loss causation requires a causal relationship between a defendant's conduct and a plaintiff's injury, allowing courts to consider factors unrelated to a defendant's alleged misconduct before imposing liability. Lest Section 10(b) become an insurance plan for unrelated losses whenever there is any misrepresentation made in connection with the purchase of a security, it simply is not enough for the plaintiff to allege only that the price of the stock was artificially inflated at the time of purchase.

4. Transaction causation and loss causation were acknowledged as separate and distinct elements in 10b-5 claims at least as early as 1974 in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974). Transaction causation, discussed *infra* at II. B.1, is typically synonymous with reliance, and only explains why the plaintiff entered into the transaction. It does not explain what ultimately caused plaintiff's loss.

The Ninth Circuit's interpretation of loss causation improperly collapses the separate elements of transaction causation and loss causation. Where a plaintiff invokes the fraud-on-the-market theory to pursue its claims under Section 10(b), such as the case is here, the plaintiff is entitled to a rebuttable presumption of reliance – i.e., transaction causation. In other words, the plaintiff is entitled to a presumption that he relied on the integrity of the market price as reflecting all material information about a company. Requiring a plaintiff to allege only that the price of stock was artificially inflated at the time of purchase effectively eliminates any substantive loss causation element. *See Emergent Capital Investment Management, LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198 (2d Cir. 2003) (a plaintiff's allegation of only purchase-time value disparity is nothing more than a paraphrased allegation of transaction causation). As noted above and discussed *infra* at II. B., transaction causation and loss causation are independent and distinct elements, both of which must be established in order to sufficiently plead a securities fraud claim under Section 10(b).

Finally, the Ninth Circuit's decision here is fundamentally at odds with the efficient market theory, upon which all fraud-on-the-market securities class actions are based. That theory holds that in well-developed capital markets, all publicly available material information about a company is quickly reflected in the price of the company's stock. Accordingly, where a security's price is artificially inflated as a result of a material misrepresentation, the inflation will necessarily carry over until the truth is disclosed and absorbed by the market, resulting in a subsequent decline in the stock's price. It is only at this point that the investor plaintiff has suffered any "loss." Allowing a plaintiff to satisfy

loss causation on an allegation of price inflation alone has the potential to create a windfall for investors who sell prior to a corrective disclosure.[5]

In sum, the Ninth Circuit's price inflation theory of loss causation runs directly counter to basic principles of statutory interpretation, the jurisprudence of loss causation, and related sound policy reasons. In order for the Congressionally mandated element of "loss causation" to have any meaningful application in securities fraud cases, particularly at the pleading stage, a plaintiff must allege some direct tie between the fraudulent conduct alleged and the decline in stock price for which they seek to recover.

ARGUMENT

I. The Ninth Circuit's Approach Is Inconsistent With The Reform Act

One of the key issues facing Congress in 1995 was substantial concern over abusive and frivolous securities lawsuits filed by "professional" plaintiffs. H.R. Conf. Rep. 104-369 at 31-33 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-731. Congress recognized that these suits were frequently filed in the hopes of obtaining quick settlements by anxious defendants who were averse to litigation. *Id.* Congress further observed that these suits and the potential resultant settlements would increase the cost of raising capital and would chill corporate disclosure. *Id.* In response to these

5. *See* SG Cert. Brief at 11 ("Measuring the loss in [a fraud-on-the-market case] as of the time of purchase, and not requiring any allegation of a subsequent loss of value attributable to the fraud, would grant a windfall to investors who sold before the reduction or elimination of the artificial inflation.").

and other concerns, Congress enacted the Private Securities Litigation Reform Act of 1995. PL 104-67, 1995 HR 1058. In passing the Reform Act, Congress sought, in part, to establish uniform and stringent pleading requirements for securities fraud actions arising under Section 10(b) of the Securities Exchange Act of 1934. In this regard, Congress codified a plaintiff's burden of pleading and proving "loss causation" in 10(b) cases. Specifically, section 21D(b)(4) of the Reform Act, entitled "Loss causation", provides that "[i]n any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4). When viewed in the context of the Reform Act's broad statutory scheme, it is clear that the Ninth Circuit's price inflation theory of loss causation is not sufficient to satisfy this Congressionally mandated requirement.

A. The Ninth Circuit's Interpretation Of Loss Causation Cannot Be Reconciled With The Reform Act's "Look Back" Damages Provision

The inconsistency between the Ninth Circuit's interpretation of loss causation and the Reform Act is particularly striking when construed with the Act's limitation on damages. In addition to codifying loss causation in the Reform Act, Congress also implemented therein an upward damages limitation in order to confine a plaintiff's recovery to those losses actually caused by the fraud and not by other market conditions for which defendants should not be held responsible. Specifically, section 21D(e)(1) of the Reform Act provides:

> Except as provided in paragraph (2), in any private action arising under this chapter in which the

> plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which *the information correcting the misstatement or omission that is the basis for the action is disseminated to the market*.

15 U.S.C § 78u-4(e)(1) (emphasis added) (reproduced at Pet. App. 54a-55a). This provision of the Reform Act has been referred to as the "look back" provision. In defining a plaintiff's damages in a Section 10(b) securities case, this provision not only imposes limitations upon the plaintiff's recovery based upon the amount of the post-transaction decline in value, but it also makes no sense unless loss causation requires that a corrective disclosure of the alleged misrepresentation or omission caused such a decline. .

The Ninth Circuit's interpretation of loss causation, which is based solely on a theory of price inflation at the time of purchase, would render the Reform Act's "look back" provision inoperative. If, as the Ninth Circuit has held, a plaintiff can establish loss causation merely by alleging that the stock was artificially inflated as the result of defendant's fraud, it presumably does not matter whether the share price actually experiences a related decline. Consequently, the 90-day "look back" period, which is intended to limit plaintiffs' potentially available damages where a stock does not decline, or declines but then recovers, is rendered moot. Similarly, the respondents here should not be entitled to any damages, even though in the Ninth Circuit's view they adequately

pleaded loss causation. Pursuant to the "look back" provision, the day the corrective disclosure is made to the public is relevant to the determination of damages. Here, the loss for which respondents sought to recover is the stock price decline that occurred on February 24, 1998. However, the "corrective disclosure" relating to Albuterol Spiros was not made until nine months later – after the close of the Class Period. Congress could not possibly have intended such an absurd inconsistency between the loss causation requirement and the "look back" provision governing the availability of damages.

Consistency with the "look back" provision requires that a plaintiff prove a causal connection between the defendant's alleged fraud and the post-transaction decline in value. Indeed, such a causal connection is necessary in order for the damages provision to have any practical effect. If a defendant's fraud did not cause the post-transaction decline, it would make no sense for that decline and any subsequent recovery to govern the damages available to the plaintiff. Moreover, as noted by the Banking, Housing and Urban Affairs Committee of the United States Senate, by including the limitation on damages provision in the Reform Act, the Committee intended to rectify the uncertainty in calculating damages in securities fraud cases, "thereby limiting damages to those losses caused by the fraud and not other market conditions." S. Rep. No. 104-98 at 20 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 699.

B. The Ninth Circuit's Understanding Of Loss Causation Cannot Be Reconciled With The Definition Of That Term In Section 105 Of The Reform Act

In addition to codifying the required element of loss causation for securities fraud actions arising under Section 10(b) of the Securities Exchange Act of 1934, the Reform Act also codified the element of loss causation as applied to private actions brought under Section 12 of the Securities Act of 1933, which expressly creates a private cause of action for material misstatements and omissions made in connection with an offer or sale of a security. PL 104-67 § 105, 1995 HR 1058; 15 U.S.C. § 77*l*(b). Notably, Section 105 of the Reform Act amended Section 12 to provide defendants in such cases with an affirmative defense of loss causation. *Id.* Although the application of "loss causation" under the two sections is different in that under Section 10(b) it is a required element of plaintiff's case, and under Section 12 it is an affirmative defense, Section 105 shows what Congress intended by the term "loss causation," thereby placing the loss causation requirement under Section 10(b) in context.

Section 105 specifically provides:

> (b) Loss causation
>
> In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

Id.

Section 105 thus clearly defines "loss causation" in terms of the link between defendant's false statements and the "depreciation in value of the subject security. . . ." Such "depreciation in value" definition of loss causation cannot be reconciled with a standard that is satisfied entirely if there is artificial inflation at the time of purchase. As illustrated by Section 105, Congress clearly intended that inflation without a decline is not a "loss" for purposes of loss causation.

When interpreting a statutory provision, this Court will consider its place in the broad statutory scheme, rather than analyzing statutory language in isolation. *Reno v. Koray*, 515 U.S. 50, 56 (1995). As this Court has explained:

> It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme. A court must therefore interpret the statute as a symmetrical and coherent regulatory scheme and fit, if possible, all parts into a harmonious whole. Similarly, the meaning of one statute may be affected by other Acts, particularly where Congress has spoken subsequently and more specifically to the topic at hand.

FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 133 (2000) (internal citations and quotations omitted).

This is the same approach this Court consistently has applied in prior interpretations of the federal securities laws. *See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174-80 (1994) (analyzing numerous provisions of the 1933 and 1934 Acts in determining not to impose aiding and abetting liability under Section 10(b)); *Chiarella v. United States*, 445 U.S. 222, 234 (1988) ("the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit").

When read in conjunction with Section 105, the only reasonable interpretation of the loss causation requirement of section 21D(b)(4) of the Reform Act is that a plaintiff in a Rule 10b-5 action has the burden to plead and prove a causal connection between the alleged fraud and a subsequent decline in stock price. The Ninth Circuit's interpretation of loss causation here inexplicably results in two different definitions of loss causation within the Reform Act, thereby violating fundamental principles of statutory construction.[6]

Collectively, the purpose of the Reform Act, its "look back" provision, and its codification of loss causation under both Sections 21D(b)(4) and 105 provide a solid basis for developing a uniform approach to loss causation – one that requires a plaintiff to plead and prove a causal connection

6. *See Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 479 (1992) ("basic canon of statutory construction that identical terms within an Act bear the same meaning"); *see also Sullivan v. Stroop*, 496 U.S. 478, 484 (1990); *cf. United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) ("A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme – because the same terminology is used elsewhere in a context that makes its meaning clear. . . .").

between the defendant's alleged misrepresentation or omission and the investment's subsequent decline in price. By removing the causal nexus that Congress intended to require, the Ninth Circuit's interpretation of loss causation frustrates the effective administration of the Reform Act and renders meaningless or superfluous several of its provisions.

II. An Allegation Of Price Inflation, Standing Alone, Is Not Sufficient To Satisfy The Loss Causation Pleading Requirement

As required by the Reform Act, a plaintiff who brings a securities fraud claim has the burden of proving that the alleged fraud of the defendant caused the loss for which the plaintiff seeks to recover damages. The Ninth Circuit here has held that in a fraud-on-the-market case, a plaintiff can establish loss causation simply by alleging that the stock's value at the time of purchase was artificially inflated as a result of the misrepresentation. As the court explained "it is not necessary that a disclosure and subsequent drop in the market price of the stock have actually occurred." Pet. App. 9a. This interpretation by the Ninth Circuit essentially renders the Reform's Act codification of loss causation meaningless.

Loss causation is a screening function that serves an important purpose. It ensures the existence of an identifiable nexus between a defendant's alleged misconduct and a plaintiff's claimed losses. Consequently, it allows courts to take account of intervening factors, such as war or a recession, that may have caused the price decline, in deciding whether and to what extent to hold a defendant in a securities fraud case liable. Indeed, it is only by requiring plaintiffs to plead a specific causal nexus between the alleged fraud and a subsequent drop in stock price that courts can identify those

legitimate losses potentially stemming from fraud, while at the same time preventing the federal securities laws from turning into a system of nationwide investor insurance. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983) ("Absent the requirement of causation, Rule 10b-5 would become an insurance plan for the cost of every security purchased in reliance upon a material misstatement or omission."); *cf. Raab v. General Physics Corp.*, 4 F.3d 286, 291 (4th Cir. 1993) ("The market has risks; the securities laws do not serve as investment insurance."). The Ninth Circuit's price inflation theory of loss causation offends these fundamental principles.

A. The Reform Act Clearly Intended To Codify Existing Case Law That The Misrepresentation Must Cause The Investment's Decline In Value

The Reform Act's statutory text and legislative history, as well as other provisions of the Act, support an interpretation of loss causation that requires a subsequent decline in the value of the stock causally related to the alleged fraud. For example, in discussing the loss causation requirement, the House Conference Report, issued in support of Congress's passage of the Reform Act, confirms that plaintiffs are required to plead and prove "that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff." H.R. Conf. Rep. 104-369 at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. Moreover, according to the Senate Report, the loss causation requirement was intended to reduce the cost of raising capital by "codifying the requirement under current law that plaintiff prove that the *loss in the value of their stock* was caused by the Section 10(b) violation and not by

other factors." S. Rep. No. 104-98 at 7 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 686 (emphasis added).[7]

The "current law" referenced by the Senate Report refers to a body of cases developing at least as early as 1981, and represented by *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981). In this seminal decision the loss causation requirement was found to be satisfied in a securities fraud case only if the misrepresentation caused the investment's decline in value. At trial, the judge submitted the case to the jury only on the issues of materiality and scienter. *Id.* at 539. Despite defendants' requests, the trial judge refused to submit to the jury issues relating to reliance and causation. *Id.*

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7. In discussing the loss causation provision to be included in the Reform Act, the House Conference Report states that a plaintiff must plead and prove that the misrepresentation "actually caused the loss incurred by the plaintiff. . . ." It further provides as an example that the "plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as a result of the misstatement or omission." H.R. Conf. Rep. 104-369 at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740; *See also* S. Rep. No. 104-98 at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 694. Neither the House nor the Senate elaborated on the "example" provided and whether additional items of proof would be required. As the Solicitor General stated in its Brief filed in support of the petition for writ of certiorari, "it is not likely that this lone sentence in the [Reform Act's] legislative history reflects a considered congressional judgment regarding how loss causation is to be established in a Rule 10b-5 case." (SG Cert. Brief at 12) The Solicitor General concluded: "A contrary conclusion would be particularly unwarranted in view of the [Reform Act's] purpose, which was to impose strict requirement on plaintiffs in private securities fraud action." *Id.*; *see also Timbers*, 484 U.S. at 380 (generalizations contained in legislative history are inadequate to overcome the plain textual meaning contained elsewhere in the statute), and *supra* at I.A. and B.

The jury entered judgment in favor of the plaintiffs. *Id.* at 539-540.

The Fifth Circuit reversed, in part, because the district court failed to submit the question of causation to the jury. *Id.* at 549, 560. The court noted that in addition to the elements of materiality and scienter, to make a claim under Section 10(b), the plaintiff must also establish reliance and causation. *Id.* at 543. Causation, the court explained, is a related but distinct element from reliance. *Id.* at 549. Unlike reliance, which requires the plaintiff to establish that had he known the truth, he would not have acted, causation requires one step further: the plaintiff must prove that the misrepresentation directly caused his loss *Id.* The court further explained: "The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value." *Id.* at 549.

Similarly, prior to the Reform Act, the leading case in the "current law" codified by the Reform Act required plaintiffs to adequately plead loss causation in order to survive a motion to dismiss. In *Bastian v. Petron Resources Corp.*, 892 F.2d 680 (7th Cir. 1990), *cert. denied*, 496 U.S. 906 (1990), plaintiffs were investors in certain oil and gas limited partnerships. *Id.* In their complaint, plaintiffs charged that had it not been for the misleading omissions and misrepresentations made by the defendants in their offering memoranda regarding defendants' competence and integrity, plaintiffs would not have invested in the then worthless partnerships. *Id.* In granting defendants' motion to dismiss under Rule 12(b)(6), the district court held that the complaint failed to allege loss causation – i.e. that if the facts had been as represented by the defendants, the value of plaintiffs'

investment in the partnership would not have declined. *Id.* at 682.[8]

On appeal to the Seventh Circuit, plaintiffs argued that they should not be required to allege that, but for the fraud, the investment that they were induced to make would not have lost its value. *Id.* at 683. Rather, plaintiffs asserted, it was sufficient to allege simply that they would not have invested but for the fraud; that if they had not invested, they would not have lost their money; and, therefore, the fraud was the cause of their loss. *Id.* Plaintiffs admitted that they had no idea why their investment was wiped out, but argued that it did not matter since defendants' fraud induced their investment in the first place. *Id.*

In affirming the dismissal, Judge Posner noted that although plaintiffs had alleged the cause of their entering into the transaction in which they lost money – i.e. transaction causation – they had not alleged the cause of the transaction turning out to be a losing one. *Id.* at 684. According to the court, the likely reason plaintiffs were not able to allege that defendants' misrepresentations caused their loss is because the plaintiffs' investments were wiped out due to a general decline in the oil industry. As such, plaintiffs would have lost their investments in oil and gas limited partnerships despite the competency and integrity of defendants or any other management. *Id.* To award damages where plaintiffs would have lost their investment regardless of the fraud, the court explained, would result in a windfall. *Id.* at 685.

8. The district court dismissed plaintiffs' original complaint with leave to amend, but warned plaintiffs that if they alleged but later failed to prove loss causation, sanctions may be imposed. Plaintiffs filed an amended complaint, but did not reallege their Rule 10b-5 claims. The district court ultimately dismissed the amended complaint with prejudice.

In *Bastian*, Judge Posner described "loss causation" as an exotic, perhaps unhappy name. *Id.* Nevertheless, in explaining the significance of establishing loss causation in securities fraud cases, the court stated: "No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda with a fine-tooth comb in the hope of uncovering a misrepresentation." *Id.* Unless a plaintiff is required to plead and prove that the alleged fraud caused their loss, the trier of fact can have no confidence that the plaintiff would be better off if the defendant had refrained from making the misrepresentation. *Id.* at 686.

The Ninth Circuit's price-inflation theory of loss causation, if applied on a nationwide basis, is revolutionary and would radically alter not only how loss causation has been applied in most circuits even before the Reform Act, but also how Congress intended it to be applied under the Reform Act. There is no basis for the Ninth Circuit's rule and, thus, no reason to adopt it.

B. The Ninth Circuit's Decision Nullifies Loss Causation As An Essential And Independent Element Under Rule 10b-5

A plaintiff bringing a cause of action for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and Securities Exchange Commission Rule 10b-5 promulgated thereunder must plead and prove causation – i.e., that the defendant's alleged misrepresentation caused the plaintiff's injury. *See* 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5. Causation in this context has two elements: transaction causation and loss causation. Loss causation was first articulated as an independent and essential element in Rule

10b-5 claims by the Second Circuit in *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), where the court defined "loss causation" as a "showing" that the defendant's unlawful conduct *caused* the economic harm. *Id.* at 380 (emphasis added). The court distinguished "loss causation" from "transaction causation" which the court defined as a "showing" that the defendant's misrepresentations or omissions caused the plaintiff to "engage in the transaction in question." *Id.*

Transaction causation is frequently viewed as synonymous with reliance, and is a type of "but for" requirement: but for the defendant's fraud, plaintiff would not have entered into the transaction. *Huddleston*, 640 F.2d 534, 549. Loss causation, however, requires a critical additional step in the analysis. *Id.* As the Fifth Circuit explained in *Huddleston*: "The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss." *Id.*

As an independent element of private securities fraud claims, loss causation is entitled to meaningful application at both the pleading stage and beyond. The Ninth Circuit's price inflation theory, which does not require a subsequent decline in stock price, takes the "loss" out of "loss causation" and as such, strips the element of its intended relevance.

1. The Ninth Circuit's Price Inflation Theory Improperly Collapses Loss Causation Into Transaction Causation

The Ninth Circuit here appeared to acknowledge that loss causation and transaction causation are distinct and independent elements of a Rule 10b-5 claim. Pet. App. 8a.

The result reached in the Ninth Circuit's holding, however, inexplicably merges loss causation into transaction causation, thereby denying the former the independent purpose it should serve in a fraud-on-the-market case such as this one.

As decided by this Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), under certain circumstances, the fraud-on-the-market theory entitles plaintiffs to a rebuttable presumption of reliance (or transaction causation) in claims brought under Rule 10b-5. *Id.* at 245-49. The rationale supporting the presumption is that efficient, well-developed capital markets rapidly reflect all publicly available information, including any material misrepresentations, into the price of securities at the time of investment. *Id.* at 246. Accordingly, "[b]ecause *most publicly available information* is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247 (emphasis added). Nothing in *Basic* supports what the respondents tried to do here: seek recovery for a decline that occurred *before* any corrective disclosure became "publicly available." Presumably, under the efficient market theory a security's price decline does not reflect the market's reaction to information that was allegedly concealed until after the decline.

Under the Ninth Circuit's view, however, a plaintiff sufficiently pleads loss causation if he alleges that the price of stock on the date of purchase was inflated a result of a misrepresentation. Pet. App. 9a. This, however, is nothing more than a restatement of the presumption of reliance – i.e., transaction causation – adopted in *Basic*. Under the efficient market theory, a material misrepresentation or omission which reflects favorably on a company will typically inflate that company's stock price. Consequently, if, under the Ninth Circuit's approach, a plaintiff invoking the fraud-on-the-market

theory need only allege a material misrepresentation or omission and artificial inflation of the stock price, the plaintiff will simultaneously satisfy the pleading requirements for both transaction causation and loss causation based upon the same "presumption," thereby improperly conflating the two.

There can be no presumption of loss causation, whether under *Basic* or otherwise, because the Exchange Act expressly provides that "plaintiff shall have the *burden of proving* that the act or omission of the plaintiff caused the loss." 15 U.S.C. § 78u-4(b)(4) (emphasis added).[9] Accordingly, most courts properly have refused to collapse loss causation into *Basic*'s presumption of reliance or transaction causation. *See Emergent Capital*, 343 F.3d at 198 (alleging a disparity in investment value at the time of purchase is, by itself, nothing more than a paraphrased allegation of transaction causation); *AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 216 (2d Cir. 2000) ("Loss causation is a separate element from transaction causation and . . . loss causation cannot be collapsed with transaction causation."); *Robbins*, 116 F.3d at 1448 (refusing to use *Basic*'s presumption of reliance "to alter the loss causation requirement" because that theory "is used to support a rebuttable presumption of reliance, not a presumption of causation."); *cf. Huddleston*, 640 F.2d at 547 (it is "a nonsequitur to conclude that the representation that induced action necessarily caused the consequences of that action.").

9. Notably, prior to the adoption of the Reform Act and its codification of loss causation, members of Congress expressed concern that some courts were adopting a presumption of loss causation, as well as reliance, in fraud-on-the-market cases. *See* Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 ("PSLRA")*, 68 Fordham L. Rev. 1781, 1811 n.273 (April 2000) (*citing* Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, Staff Report on Private Securities Litigation 228 (May 17, 1994) (prepared at the direction of Sen. Dodd)).

2. The Ninth Circuit's Interpretation Of Loss Causation Is Counterintuitive To The Efficient Market Theory

The Ninth Circuit's approach regarding loss causation simply cannot be reconciled with the fundamental premise underlying the fraud-on-the-market theory – the efficient market theory. Under the efficient market theory, if a stock price is inflated as the result of a material misrepresentation disseminated to the investing public, such inflation will necessarily carry over until the true facts are revealed through a corrective disclosure. It is at this point that the market will correct itself and the price of the stock will decline. As explained by the Third Circuit in *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3rd Cir. 2000):

> Where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation. In the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.

Id. at 185. Accordingly, an investor in a fraud-on-the-market case who purchases a security at an artificially inflated price cannot be said to have suffered any economic loss as a result of the alleged misrepresentation until the "truth" is disclosed and absorbed by the efficient market thereby causing the stock price to drop.

If the fraud-on-the-market theory is going to have any principled consistency, loss causation based on a price decline in response to disclosure of the alleged fraud is a necessary element of a fraud-on-the-market case. Since plaintiffs have the benefit of the efficient market theory to obtain a presumption of transaction causation, they should not be allowed to ignore or contradict the logical consequences of that theory when it comes to their obligation to plead and prove loss causation. Defining loss causation in terms solely of artificial inflation at the time of purchase, as the Ninth Circuit here has done, divorces "loss causation" from the reality of the market's response and renders its application meaningless.[10]

C. The Ninth Circuit's Reliance On A Price Inflation Theory To Satisfy Loss Causation Contravenes Established Tort Principles

As illustrated in *Central Bank*, this Court has been unwilling to interpret the judicially-implied private right of action under Section 10(b) as broadly as the common law.[11] *Central Bank*, 511 U.S. at 180. In particular, here Congress has itself defined "loss causation" to require "depreciation in value resulting from" the specific misstatement. 15 U.S.C.

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10. Petitioners respectfully refer the Court to the Amicus Brief of the Securities Industry Association, *et al.* It contains a fuller explanation of how the Ninth Circuit's loss causation rule contradicts *Basic* and the efficient market hypothesis. It also explains more fully the adverse implications for the securities markets, market participants, and investors from the Ninth Circuit's loss causation rule.

11. For a full discussion of how this Court has repeatedly limited the scope of liability under Section 10(b), petitioners respectfully refer the Court to the Amicus Brief of Merrill Lynch & Co., Inc.

§ 77*l*(b); *see supra*, at I.B. Thus, there is no reason to look to the common law for a definition that Congress itself provided. There are no statutory interstices to fill. Even assuming for the sake of argument, however, that common law proximate causation principles were relevant to defining loss causation under Section 10(b), those principles also require that a specific misrepresentation cause not merely a plaintiff to buy a security, but also a specific subsequent decline in the security's price.

Both Prosser, Law of Torts[12] and the Restatement (2d) of Torts show this. These authorities illustrate that there is no liability when the value of stock declines, not as a result of the misrepresentation which induced the transaction in the first place, but rather as a result of other factors in no way related to the fraudulent misrepresentations.[13]

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12. *See* W. PROSSER & W. KEETON, PROSSER AND KEETON ON TORTS ¶ 110, at 767 (5th ed. 1984):

> . . . if false statements are made in connection with the sale of corporate stock, losses due to a subsequent decline of the market, or insolvency of the corporation, brought about by business conditions or other factors in no way related to the representations, will not afford any basis for recovery.

13. As the Restatement (2d) of Torts points out, one who misrepresents the financial condition of a company in order to sell stock will be liable to the purchaser who relies on the misrepresentation for the losses incurred when the facts regarding the company's finances are disclosed and the stock subsequently declines in value. However,

> there is no liability when the value of the stock goes down after the sale, not in any way because of the

(Cont'd)

The following hypothetical from the Restatement (2d) of Torts is particularly helpful

> A, seeking to sell to B the municipal bonds of C County, fraudulently tells B that the county has received full payment for the bond issue. B purchases the bonds in reliance upon this statement. Subsequently, the county is paid in full, but the bonds are held void by the supreme court of the state on the ground that the court had no jurisdiction to issue certain orders with respect to them. As a result B suffers pecuniary loss. A is not liable to B for the loss.

RESTATEMENT (SECOND) OF TORTS § 548A cmt. b, illus. 1 (1977). Under this scenario, it would not be enough to allege that the price of the bonds was artificially inflated as a result of A's misrepresentation about full payment. The misrepresentation was not the cause of the subsequent decline in the value of the bonds, and thus, the failure to establish causation precludes recovery.

(Cont'd)

> misrepresented financial condition, but as a result of some subsequent event that has no connection with or relation to its financial condition. There is, for example, no liability when the shares go down because of the sudden death of the corporation's leading officers. Although the misrepresentation has in fact caused the loss, since it has induced the purchase without which the loss would not have occurred, it is not the legal cause of the loss for which the maker is responsible.

RESTATEMENT (SECOND) OF TORTS § 548A cmt. b (1977).

D. The Ninth Circuit's Price Inflation Theory Creates A Potential Windfall For Certain Investors

The potential consequences of allowing a plaintiff to pursue a securities fraud claim based on an allegation of price inflation alone cannot be ignored. Notably, the price-inflation theory of loss causation has the potential to allow plaintiffs to satisfy the pleading requirement for loss causation even where they have suffered no loss. Take, for example, an "in-and-out" investor, who both purchases and sells his stock at an inflated price. Suppose that the amount of inflation is constant and that this investor bought a share of stock for $50, which in reality was worth only $10, but also sold that share of stock at $50, thereby breaking even in the process. Under the Ninth Circuit's interpretation of loss causation, a plaintiff need only allege price inflation at the time of purchase. Because the Ninth Circuit does not require a subsequent decline in stock price, the in-and-out investor plaintiff could satisfy the loss causation pleading requirement by simply alleging that the stock was overpriced by $40 at the time of purchase, even though the investor suffered no loss. As the Third Circuit recognized in *Semerenko*, "[i]n the absence of a correction in the market price, the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price." 223 F.3d at 185. Accordingly, the Ninth Circuit's price inflation theory of loss causation has the potential to create a windfall for in-and-out investors and others.

III. Respondents' Anticipated Alternative Theories Of Loss Causation Are Unsustainable

Respondents may argue that the November 3, 1998 price decline – nine months after the February 24, 1998 termination of the Class Period – is somehow relevant to establishing loss causation here. To this point, however, respondents' theory of loss causation has been focused purely on an allegation of price inflation at the time of purchase. Respondents have rejected any notion that the loss causation analysis must be based on a subsequent change in the stock's price. *See* JA 205a ("Under this [Ninth] Circuit's law . . . [t]he correct focus is on the stock's inflation at the moment of purchase – not on its price at some later time.").

Nowhere in either the Consolidated Amended Complaint or the operative Second Amended Complaint do respondents even allege the November 3, 1998 price decline. *See* SER 37, JA 34a-141a. Similarly, respondents did not address the November 3 price decline anywhere in their opposition to defendants' motion to dismiss plaintiffs' Second Amended Complaint. (*See* U.S. District Court, Southern District of California, Civil Docket for Case #: 99-CV-151, docket number 83). The district court's grant of a Rule 12(b)(6) dismissal could not be reversed – either by the Ninth Circuit or this Court – based on an allegation and argument never made in the district court.

In fact, the only mention respondents make of this price decline is a cursory reference to it in their Opening Brief to the Ninth Circuit. JA 208a. Even then, respondents neither argued that it was a loss for which they ought to recover, nor did they assert it as a basis for establishing loss causation. *See* JA 204a-208a.

The reality is that the November 3, 1998 price decline is irrelevant to respondents' claims. A plaintiff who brings a securities fraud claim "shall have the burden of proving that the act or omission of the defendant alleged to violate [the Exchange Act] *caused the loss for which the plaintiff seeks to recover*." 15 U.S.C. § 78u-4(b)(4) (emphasis added). This requirement applies equally at the pleading and proof stages. Respondents' Class Period ends on February 24, 1998. JA 34a: ¶ 1. The "loss" for which respondents sought to recover in the district court and court of appeals is that associated with the 47% price decline that occurred between February 24, 1998 and February 25, 1998. JA 34a-141a: ¶¶ 32, 39, 134, 172. Not surprisingly, respondents strategically elected to end their Class Period on February 24, 1998, with the 47% price decline, and not nine months later, with the temporary 21% price decline, where the shares immediately rebounded. *See supra*, at Statement of the Case. In short, because the November 3, 1998 price decline bears no relationship to respondents' stated class period and the associated loss for which respondents sought to recover, it is irrelevant to their claims.

Respondents may also argue that a decline in stock price is not necessary to establish loss causation, such as in a case where the disclosure of negative and positive information results in an overall net increase in stock price and thus a masking of the reduction in price caused by the negative disclosure. Even apart from the inherent speculation in such an argument, such a hypothetical case has no application here because respondents have not alleged a post-disclosure price reduction masked by other positive information. Instead, respondents sought to recover losses for the February 25, 1998 decline in stock price, which, by their own admission, is not causally related to any representations regarding

Albuterol Spiros. As discussed above, respondents' theory of loss causation has always been based purely on alleged inflation at the time of purchase without a subsequent decline in stock price at any time – whether masked or otherwise. *See* JA 205a ("The correct focus is on the stock's inflation at the moment of purchase – not on its price at some later date."). Moreover, even where a decline in stock price is masked by the simultaneous disclosure of positive and negative information, in order to properly plead loss causation, a plaintiff must still allege a causal connection between the alleged fraud and an actual reductive effect in the price of the stock from what it otherwise would have been.

CONCLUSION

For the foregoing reasons, petitioners respectfully request that the Supreme Court reverse the Ninth Circuit decision below with respect to respondents' claims regarding Albuterol Spiros.

Respectfully submitted,

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